

**REPORT OF
FINANCIAL EXAMINATION**

MISSOURI UNITED SCHOOL INSURANCE COUNCIL

AS OF

DECEMBER 31, 2004

STATE OF MISSOURI

DEPARTMENT OF INSURANCE

JEFFERSON CITY, MISSOURI

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Honorable W. Dale Finke, Director
Missouri Department of Insurance
301 West High Street, Room 530
Jefferson City, MO 65101

August 19, 2005
Saint Louis, Missouri

Sir:

In accordance with your financial examination warrant, a financial examination has been made of the records, affairs and financial condition of

Missouri United School Insurance Council

also referred to as "MUSIC" or as the "Association." The examination was conducted at Arthur J. Gallagher and Company, the Association's broker, 12444 Powerscourt Drive, St. Louis, Missouri, 63131, telephone number (314) 965-4346. This examination began on July 11, 2005 and concluded August 19, 2005.

SCOPE OF EXAMINATION

Period Covered

The prior financial examination of Missouri United School Insurance Council was performed as of December 31, 2001. The examination was conducted by an examiner from the state of Missouri.

The current full scope financial examination covers the period from January 1, 2002, through December 31, 2004. The examination was conducted by an examiner from the state of Missouri.

This examination also included material transactions and/or events occurring after December 31, 2004.

Procedures

This examination was conducted using the guidelines set forth in applicable regulations of the Missouri Department of Insurance (“MDI”) and statutes of the state of Missouri. The workpapers of the Association’s independent auditor, Conner Ash, P.C., were made available to the examiner. Standard examination procedures were modified as deemed appropriate under the circumstances.

Comments Previous Examination

Listed below are the comments and recommendations taken from the prior examination report as of December 31, 2001. The responses or actions taken by the Association are also described below.

Comment: Comments Previous Examination

“The Association is responsible for remitting abandoned funds to the State of Missouri. To date, the Association has never filed an unclaimed property report with the Missouri State Treasurer. The Association is directed to develop procedures to monitor outstanding checks and to report unclaimed property to the State of Missouri as required by Chapter 447 RSMo (Lost and Unclaimed Property).”

Response:

“The procedures and systems were implemented per MUSIC’s DOI response. (MUSIC) will be ready to begin reporting in January 2006.”

Current Findings:

The Association has developed procedures for aging and reporting abandoned checks.

Comment: Conflict of Interest

“It is recommended that the Association require its officers and directors to complete a conflict of interest statement on an annual basis.”

Response:

MUSIC indicated that it had complied with this recommendation.

Current Findings:

Conflict of interest forms were completed by all officers and directors for each year under examination.

Comment: Financial Statements

“It is recommended that the Association take precautionary measures to safeguard its bank account balance in excess of FDIC limits.”

Response:

The Association indicated that it had complied with this recommendation by collateralizing its bank account.

Current Findings:

The Association has complied with this recommendation.

HISTORY

General

MUSIC was formed on December 4, 1985 under Chapter 537 RSMo to provide risk management for its member public school districts, junior college districts and public community colleges. Forty-seven districts instituted the Association with an initial assessment of \$2,286,692. The Association currently has four hundred seventy members. The assessment for 2004 was \$49,758,795.

Capital Stock

The Association is a not-for-profit entity and has no capital stock.

Dividends

Section 537.635 RSMo (Entity to be treated as corporation--not to produce profit-may pay dividends, when) permits the paying of dividends provided the Association has a positive surplus both before and after the dividend is declared. MUSIC has not paid any dividends since its inception.

Management

The Board of Directors consists of nine members duly elected by the membership as authorized by the by-laws. Directors serving as of December 31, 2004 were:

<u>Director</u>	<u>District</u>
Paul Fedchak	Clayton
Steve Bounds	Doniphan
Bernard DuBray	Fort Zumwalt
Sally Knight	Gasconade County R-II
Larry Ewing	Fort Osage R-I
Leroy Winkle	South Callaway County R-II
Brad Barwick	Three Rivers CC
Martin Garrison	Bolivar
Richard Davis	Howard County R-II

Officers serving as of December 31, 2004 were:

Chairman	Paul Fedchak
Vice-Chairman	Leroy Winkle
Secretary	Steve Bounds
Treasurer	Bernard DuBray
Executive Director	Gary VanMeter

The Association by-laws authorize the formation of an Executive Committee consisting of the officers of the Association. The Executive Committee is empowered to conduct those items of business that do not require action by the entire Board but that should not rest solely with the Executive Director.

Conflict of Interest

MUSIC has a policy requiring officers and directors to complete conflict of interest disclosure statements annually. The conflict of interest statements were reviewed for each year during the examination period. No material conflicts were indicated on any of the statements.

Corporate Records

The minutes of the Board of Directors meetings and of the General Membership meetings held during the examination period were reviewed. The minutes appear to properly support and approve the corporate transactions and events for the period under examination.

On January 25, 2002, the Association adopted Restated Articles of Association and Second Amended and Restated By-Laws. Changes to the Articles of Association included: naming the Executive Director as the registered agent; restating the number of original members and revising the amount of the initial assessment; changing the assessment submission date from September 1 to October 1; allowing the Executive Director to set variances from average assessments; setting the delinquent assessments charge at 1 percent per month; allowing the Executive Director to set the effective date of new memberships; and, requiring membership applications thirty days prior to the proposed effective date. The Second Amended and Restated By-Laws incorporated several changes. The most significant changes were: removing the provision for automatic election to Board of Directors for certain members; removing the provisions for weighted voting; requiring a five-year waiting period for readmission to the Association; and, allowing the Board to determine the Association's fiscal year. The Restated Articles of Association and the Second Amended and Restated By-Laws were properly adopted by the Board of Directors.

Acquisitions, Mergers and Major Corporate Events

There have been no acquisitions, mergers or other major corporate events during the examination period.

Surplus Debentures

MUSIC has not issued any surplus debentures.

AFFILIATED COMPANIES

The Association is not a member of a holding company nor does it have any subsidiaries or affiliates.

FIDELITY BOND AND OTHER INSURANCE

MUSIC maintains a \$25,000 fidelity bond on the Association treasurer. Each Association member is also covered by a \$25,000 treasurer fidelity bond. The Association is also covered by a \$250,000 employee theft policy and by a \$1,000,000 trustees' errors and omissions policy. In addition, MUSIC has the following coverage, which is provided to all Association members:

<u>Coverage Type</u>	<u>Limit</u>
General Liability	\$2,250,000 per occurrence
Crime Coverage	\$1,000,000
Workers' Compensation	Statutory
Employer's Liability	\$1,000,000

EMPLOYEE BENEFITS

The Association has an employment agreement with its Executive Director. Under the agreement, the Executive Director receives vacation, sick leave, medical, dental and life insurance benefits. The Association does not provide pension or retirement benefits to employees.

STATUTORY DEPOSITS

Missouri statutes do not require the Association to maintain funds on joint deposit with the state.

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operations

MUSIC is licensed by the Missouri Department of Insurance under Chapter 537 RSMo (Torts and Actions for Damages). Public school districts and community colleges in the state of Missouri comprise the membership of the Association. At year-end 2004, the Association had 470 members.

MUSIC contracts with consultants to perform many of its insurance functions.

These contracts are described below:

Broker Contract

Arthur J. Gallagher & Company is the broker of record for MUSIC and provides the following services under contract:

- Marketing and selection of reinsurers
- Premium accounting and allocation
- Oversight of the loss control function
- Evaluation of the Association's insurance program
- Review of all contracts entered into by the Association
- Arbitration of loss settlements

The fees paid to Arthur J. Gallagher & Company during the examination period were as follows:

<u>Year</u>	<u>Service Fee</u>	<u>Percentage of Assessments</u>
2002	1,082,252	3.20%
2003	1,125,540	2.80%
2004	1,164,936	2.30%

Claims Administration Contract

Gallagher Bassett Services, Inc. provides claims administration adjudication and loss control and prevention services for MUSIC. These services also include providing seminars and training sessions for member school districts in order to reduce or eliminate losses.

The fees paid to Gallagher Bassett Services, Inc. under this contract were as follows:

<u>Year</u>	<u>Service Fee</u>	<u>Percentage of Assessments</u>
2002	1,598,632	4.80%
2003	1,781,653	4.40%
2004	1,898,843	3.80%

Policy Forms & Underwriting

Under Chapter 537 RSMo, the Association is not required to submit its policy forms or premium rates to the Missouri Department of Insurance. The Board of Directors reviews all school districts before acceptance into the Association.

MUSIC has a blanket policy called the Plan Document which is issued to all members. As described in the Plan Document, the following coverage is provided to all members:

- Property Coverage
 - Building and Contents
 - Special Property
 - Inland Marine
- Crime Coverage
 - Crime
 - Treasurer's Bond
- Boiler and Machinery Coverage
- Liability Coverage
 - Comprehensive General Liability
 - Employment Practices Liability
 - School Board Legal Liability
 - Miscellaneous Medical Malpractice
- Automobile Coverage
 - Automobile Liability
 - Automobile Physical Damage
- Workers' Compensation Coverage
 - Workers' Compensation
 - Employer's Liability

Advertising and Sales Materials

MUSIC advertises on a limited basis. A review of the Association's advertising did not indicate any misrepresentations.

Treatment of Policyholders

MUSIC is not required to maintain a record of members' complaints. However, the Association does appear to address its members' concerns.

REINSURANCE

General

The Association uses excess reinsurance agreements to provide coverage for its member school districts. The Association's per occurrence retention limits for 2004 were as follows:

Workers' Compensation	\$400,000
Automobile Liability	\$250,000
General Liability-Occurrence	\$250,000
General Liability-Claims Made	\$250,000
Property	\$500,000

Assumed

The Association does not assume any reinsurance business.

Ceded

For 2004, MUSIC had the following excess insurance coverage limits:

General Liability	\$2,000,000
Automobile Liability	\$2,000,000
School Board Legal Liability	\$2,000,000
Property	\$500,000,000
Workers' Compensation	Statutory
Employer's Liability	\$1,000,000
Crime	\$1,000,000
Boiler & Machinery	\$100,000,000
Special Events	\$1,000,000
Trustees' Errors & Omissions	\$2,000,000

The Association's reinsurance coverage is brokered by Arthur J. Gallagher and Company. Several reinsurers participate in the excess property coverage at various levels. The Association appears to have obtained sufficient excess coverage.

It was noted during the examination that several of the Association's reinsurance agreements do not contain an insolvency clause. It is recommended that the Association require its reinsurance carriers to include this clause in all reinsurance agreements.

ACCOUNTS AND RECORDS

The Association is audited annually by an independent accounting firm. The Association's auditor for the years under examination was Conner Ash, P.C.

The Association's reserves were established by CAI Casualty Actuaries, Inc.

FINANCIAL STATEMENTS

The following financial statements present the financial condition of the Association as of December 31, 2004, and the results of operations for the year then ended. Any examination adjustments to the amounts reported in the financial statements or comments regarding such are made in the "Notes to the Financial Statements," which follow the financial statements.

There may have been additional differences found in the course of this examination which are not shown in the "Notes to the Financial Statements." These differences were determined to be immaterial in relation to the financial statements and therefore were only communicated to the Association and noted in the workpapers for each individual item.

ASSETS

Cash and cash equivalents	\$ 43,087,468
Investments	38,791,569
Member assessments receivable	16,695,101
Accrued investment income	331,329
Reinsurance recoverable on paid claims	672,635
Reinsurance recoverable on unpaid claims	17,849,422
Prepaid expenses	<u>229,475</u>
TOTAL ASSETS	<u>\$ 117,656,999</u>

LIABILITIES AND MEMBERS' FUND BALANCE

Unearned member assessments	\$ 58,527,139
Claim and claim adjustment expense reserve	21,000,000
Accounts payable and accrued expenses	299,647
Liability for uncleared checks and drafts	2,706,292
Claim and claim adjustment expense reserve	39,475,961
Advance from reinsurer	<u>1,675,282</u>
TOTAL LIABILITIES	\$ 123,684,321
MEMBERS' FUND BALANCE (Note 1)	<u>\$ (6,027,322)</u>
TOTAL LIABILITIES AND MEMBERS' FUND BALANCE	<u>\$ 117,545,387</u>

STATEMENT OF OPERATIONS

Members assessments	\$ 49,758,795
Interest income, net	1,559,054
TOTAL REVENUES	<u>\$ 51,317,849</u>
Incurred claims and claim adjustment expenses	\$ 34,843,882
Premiums for excess reinsurance coverage	13,298,541
Insurance services	3,588,151
General and administrative	282,033
Premium taxes	1,129,012
TOTAL EXPENSES	<u>\$ 53,141,619</u>
EXPENSES OVER REVENUES	\$ (1,823,770)
NET CHANGE IN F.V. OF INVESTMENTS	\$ (583,058)
MEMBERS' FUND BALANCE, prior year	\$ (3,620,494)
MEMBERS' FUND BALANCE, current year (Note 1)	<u>\$ (6,027,322)</u>

NOTES TO THE FINANCIAL STATEMENTS

Note 1

MUSIC reported a negative members' fund balance at year-end 2004 and at year-end 2003. Factors contributing to the Association's deficit included severe storm losses in 2003 and 2004, settlement of a large abuse claim, reduced investment income, reduced investment market values and an error in the discounting of workers' compensation claims. The Association has discussed its financial situation with the Missouri Department of Insurance and is currently submitting quarterly financial reports to MDI. MUSIC's current projections estimate elimination of the deficit by early 2006.

EXAMINATION CHANGES

There are no examination changes.

GENERAL COMMENTS AND RECOMMENDATIONS

Reinsurance

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It was noted during the examination that several of the Association's reinsurance agreements do not contain an insolvency clause. It is recommended that the Association require its reinsurance carriers to include this clause in all reinsurance agreements.

Members' Fund Balance

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The Association reported a negative members' fund balance at year-end 2004 and year-end 2003 (see Note 1 above). The Association has discussed its financial situation with MDI. The Association should take steps to ensure that a positive members' fund balance is achieved by early 2006.

SUBSEQUENT EVENTS

The Association prepared a loss projection summary as of July 31, 2005 and an updated budget for September 2005. According to the projections, the Association had reduced its members' fund deficit to (\$568,765) by June 30, 2005 and estimated a positive fund balance of \$1,671,514 by year-end 2005.

ACKNOWLEDGMENT

The assistance and cooperation extended by the officers of Missouri United School Insurance Council during the course of this examination is hereby acknowledged and appreciated.

VERIFICATION

State of Missouri)
) ss
City of St. Louis)

I, Thomas J. Cunningham, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of the Association, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.


Thomas J. Cunningham, CPA, CFE
Examiner-in-Charge
Missouri Department of Insurance

Sworn to and subscribed before me this 16th day of September, 2005.
My commission expires:

5/9/2009
JULIE KATSARAS
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires 5/9/2009
Commission # 05707910


Julie Katsaras
Notary Public

SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with the National Association of Insurance Commissioners procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.


Christiana Dugopolski, CPA, CFE
Audit Manager
Missouri Department of Insurance



Dr. Gary VanMeter, Executive Director
P.O. Box 1950
St. Charles, MO 63301

OFFICE (636) 916-3433
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DIRECTORS

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Vice-Chairman
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October 31, 2005

R E C E I V E D
MO INS DEPT
NOV 04 2005

Mr. Kirk Schmidt, CFE, CPA
Chief Financial Examiner
Missouri Department of Insurance
Harry S. Truman State Office Building, Room 530
301 West High
Jefferson City, MO 65101

Dear Mr. Schmidt:

Please let this letter serve as the official response of the Missouri United School Insurance Council (MUSIC) to the Department's Examination Report dated August 19, 2005 and your letter dated October 3, 2005. Please include this response in the report as a public document.

Our responses to your two General Comments and Recommendations can be found below:

1. Reinsurance –

Department:

It was noted during the examination that several of the Association's reinsurance agreements do not contain an insolvency clause. It is recommended that the Association require its reinsurance carriers to include this clause in all reinsurance agreement.

Response:

An insolvency clause will be requested of all reinsurance carriers at the Association's December 31, 2005 renewal, and thereafter.

2. Members' Fund Balance –

Department:

The Association reported a negative members' fund balance at year-end 2004 and year-end 2003. The Association has discussed its financial situation with MDI. The Association should take steps to ensure that a positive members' fund balance is achieved by early 2006.

Response:

The Association is currently projecting that there will be a positive members' fund balance by the end of 2005, or during the first quarter of 2006. While every effort is being taken to bring this about, there will always be some inherent degree of uncertainty within a risk financing organization. The Association will continue to submit quarterly, unaudited financial statements to MDI for review and comment.

Thank you very much and if you have any questions at all, please do not hesitate to contact me.

As was the case three years ago, we would again like to compliment Mr. Tom Cunningham on his very professional manner throughout the examination process.

Sincerely,



Dr. Gary VanMeter
Executive Director

cc: Paul Fedchak - Board Chairman